



CORPORATE GOVERNANCE IN FINANCIAL SERVICES

Lecturer Işık AKIN

Istanbul Gelisim University, iakin@gelisim.edu.tr

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ABSTRACT

After the banking crisis, more effective and stricter corporate governance framework is established by reviewing the Combined Code on corporate governance (UK's principal regulation on corporate governance) by UK authorities. Financial Reporting Council which is UK's independent regulator of corporate governance made changes in parallel with the Walker review.

There is an extremely controversial debate about whether failures in the corporate governance of banks were a major cause of the financial crisis. The most of time the truth is in the middle. Actually deficiencies in board practices and profile, compensation practices as well as risk management and internal control failures are inspired by false incentives. Complex and opaque bank structures aggravated this situation. During the time that the contributory role played by these deficiencies, also there were many other and more important causes that led to the financial crisis.

1. INTRODUCTION

Companies and banks are controlled and directed by the system called corporate governance (Cadbury Report, 1992, pp.179-211). The OECD (2004) defines the corporate governance as a concept that includes a set of relationships between management of the company, its shareholders, other stakeholders and its board.

According to financial institutions the scope of corporate governance is more than the insurance policy holders, shareholders (equity governance) and other creditors (debt governance) (Hopt, 2013, pp. 219-253). The corporate governance of banks is generally different than that of a generic firm due to prudential regulations and deposit insurance (Mulbert, 2010, pp. 58). The banks' business has become more opaque and more complex. Furthermore, banks have become much larger and expanded significantly into other businesses (Mehran et al, 2011, pp. 1-24).

According to Marcinkowska (2013, pp.47-67) banks' ineffective and weak corporate governance mechanisms are identified as the main factors that contribute to the recent financial crisis. The links with USA put the UK banks in a huge systemic risk. Overdependence on short-term wholesale funding and regulatory failures caused the fall of Northern bank which was the beginning of UK banking crisis.

In UK banks development of corporate governance has not been specified early enough until the banking crisis and the finding was that the risk management, shareholder control issues and role of board of directors has not been improved after WorldCom and Enron. Thus the banking crisis is forced in a manner by important failures and mistakes (Abdumavlonov, 2012, pp.6-30).

Thereby, the aim of this essay is to discuss the reason of the corporate governance failings of UK banks and giving recommendations for improvement.

2. RISK MANAGEMENT

The risk management teams and audit committees of UK banks was found ineffective. The reason is the operations' riskiness depending on securitization and swap market was not taken into consideration by boards of the banks chasing after short-term profits. Overreliance on credit ratings in determining inherent risk is another reason of ineffectiveness of risk management, because credit rating agencies involved in scandals many times. Artificially given high ratings to pools of mortgage debts caused a global financial crisis scandal that involves CRA (Bank of England, 2008, pp.15-67).

Additionally shareholder model of corporate governance had failed due to concentration on short term goals. Furthermore, CDS contracts had a significant role for mortgage lenders, as the protection reduced the risk of repayment of loan in case of default. But counterparty risk occurs when the other party to CDS contract couldn't be able to pay in case of default (Abdumavlonov, 2012, pp. 6-30).

3. REMUNERATION AND EXECUTIVE INCENTIVES

One of the main reasons for the UK banking crisis is remuneration issues such as bonus driven remuneration strategies. The argument is executives receive high bonuses in good times of the firms and during the worst time they still receive bonuses. Executives had no losses even if the company fails (House of Commons Treasury Committee, 2009, pp. 34-45).

This payment structures aimed to give incentives to executives for better performance but it failed and acted as a ground for excessive risk taking up to crisis (See Appendix).

4. SHAREHOLDER ENGAGEMENT

UK corporate governance model differentiates from other models with its distributed ownership systems in which share ownership is divided into many small pieces. Free rider problem is due to lack of shareholder engagement in which executives could decide on their own on the issues of future prospects of a firm.

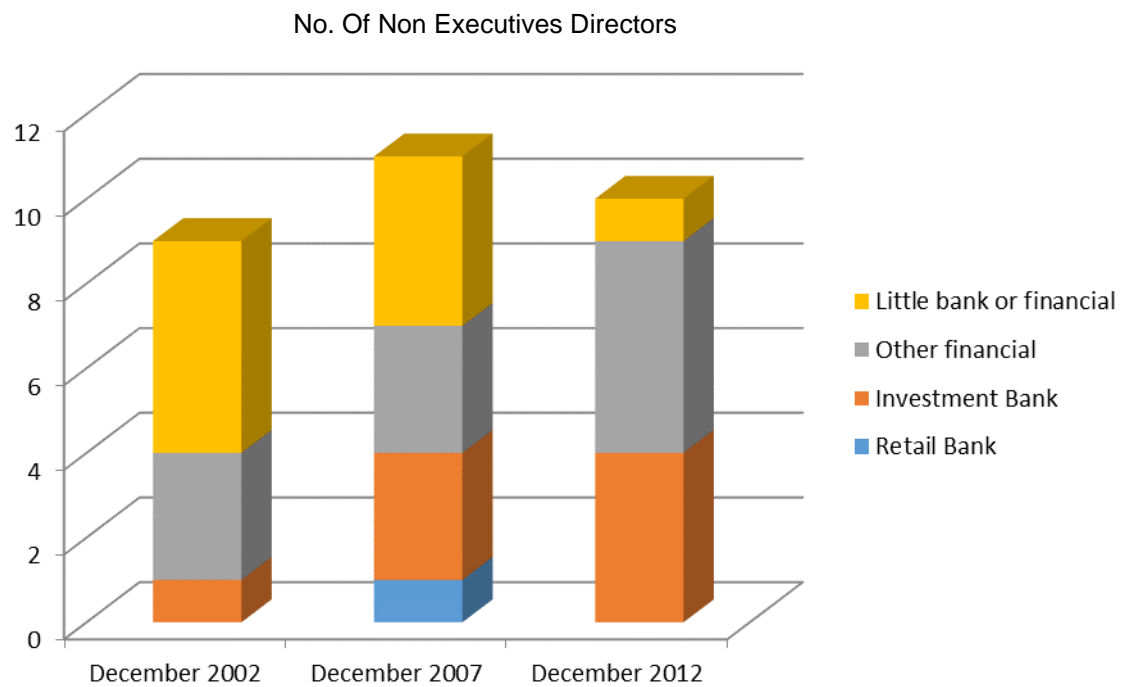
In sum lack of monitor and control by shareholders caused short termism and excessive risk taking. The dispersed ownership system made shareholders more passive, relying on boards to monitor and doing nothing for controlling their firms. During the crisis, rather than monitoring the company to escape bankruptcy, many of institutional shareholders sold out the shares or gave up. Also, weak monitoring of shareholders creates 'ownerless corporations' where executives feel free to act on their own (Abdumavlonov, 2012, pp. 6-30).

5. BOARD EFFECTIVENESS

Lack of boards' effectiveness, especially passivity of non-executive directors (NED) was one of the ascertained governance flaws during the 2007 UK banking crisis. Many of the scholars and politics like Sir David Walker, Turner and the report of Treasury Committee stated the present problem including the influence of CEOs over the most company operations.

Most of the UK financial institutions as banks had inexperienced NEDs who had no time to fulfil their obligations in the bank due to commonality of an individual's being NED in several institutions. The chairman of boards of Northern Rock, who had no expertized in finance, can be a good example.

Figure 1: Banking and Financial Expertise of Barclays NEDs (2002-2012)



Source: Salz Review, 2013

As it is illustrated in figure 1 Barclays reduced the number of NEDs with little expertise. Barclays' CEO emphasizes the significance of the boards of banks' directors being experienced and having strong understanding of banking sector. He adds currently NEDs are mostly inexperienced and it is extremely desirable to have the board people with understanding of financial sector (Abdumavlonov, 2012, pp. 6-30).

6. BANKING BUSINESS AND BANK STRUCTURES

The financial crisis literature emphasized that the banking business is, or has become, more complex and opaque than nonfinancial business (Hopt, 2013, pg.219-253). Especially, cross-border and groups banking reflect this in bank structures. When the financial crisis started, the boards of the banks have not been able to adequately control the risk-taking of their management, nor have the auditors, the rating agencies and the supervisors.

Particularly banks' systemic risks have been underestimated or have not been recognized. It is common to hear slogans like it is too connected or big to fail. This complexity and opaqueness has increased by the development of progressively complicated bank structures and difficulties in evaluating and understanding them (e.g. the Citi group has 2,500 subsidiaries and operates in 84 countries) (Hopt, 2013, pg.219-253).

Nowadays as opposed to past majority of the large international financial institutions are financial conglomerates combining two or all three of these functions. Some of the institutions are so complex that they are systemically relevant. This complexity and opaqueness of banking business and bank structures has led to grave risk management and internal control failures (Mehran et al, 2011, pp. 1-24).

7. WHO IS TO BE BLAMED?

Two main flaws of NEDs role is the reason of criticism by HM Treasury. Firstly, NEDs are not qualified and experienced enough to cope with complex and large financial institutions (House of Commons Treasury Committee, 2009, pp. 34-45). Financial Stability Board (FSB)

(2013) report supports this argument. Secondly, work overload of NEDs causes the sufficient time or resources to devote. Therefore, they are not able to provide required checks and balances by their indicative role (Chambers, 2009, pp. 264-270).

On the other hand, institutional shareholders are partly to blame for failing to prevent bank boards pursuing the policies that caused the current crisis. However, it is believed this misunderstands the power and influence of institutional shareholders'. Institutions can not change boards easily, when things go wrong. Even though, it is Royal Bank of Scotland' one of the largest shareholders, Legal & General discovered that problem. Large shareholders are restricted to public information like everyone else. Notwithstanding, more than 30 years in the business, the extent of banks' off-balance sheet vehicles like structured investment vehicles (SIVs) was not informed to him. Even he had been aware and more information is demanded, it is suspected that boards would refuse this request with the excuse of commercial sensitivity which means such information could not be revealed to just one shareholder, or to anyone else (Bolton, 2009). Accordingly, loyal shareholders who funded the banks' rights issues and are today showing a large loss on those investments can be blamed for pushing bank boards to pursue aggressive growth strategies, but not for the crisis.

In sum, most of the time directors were incapable to dedicate enough time to understand the firm's business model and too deferential to senior management. Board members of failed banks have publically apologised for the economic crisis and their role in causing the harmful events (Chambers, 2009, pp. 264-270).

8. RECOMMENDATIONS

8.1. Recommendation 1: Governance of Risk

Separation of a board risk committee from the audit committee should be first step. The responsibilities of the board risk committee should be for advice and oversight to the board on the current risk exposures of the entity and future risk strategy. Also liquidity management and strategy for capital should be included.

The board risk committee should assure that account has been taken of the current and prospective macroeconomic and financial environment drawing on financial stability assessments. (e.g. those published by the FSA, the Bank of England and other authoritative sources that may be relevant for the risk policies of the firm) (Walker, 2009, pp. 90-103). Barclays was a leading bank in establishing a separate Board Risk Committee more than 10 years ago, before most other banks (Salz Review, 2013). Also this recommendation is supported by ACCA's (2009) report.

Additionally, there should be separate report in the annual report and accounts titled as the board risk committee (or board) risk. This report should contain the strategy of the risk management context including information on the key risk exposures inherent in the strategy (Walker, 2009, pp. 90-103).

8.2. Recommendation 2: Frequency of Board Meetings

To meet the challenge of the dynamic market environment, of the kind observed in 2008, the board meetings was not frequent enough. On the other hand, it is not administratively possible for a full board to meet more frequently than once every 4-6 weeks. The recommendation 15 states that a smaller sub-group of the board, an "alpha-team" of key executive directors (the CEO, CFO, 1 business line head, Treasury head and 1 or 2 non-executive directors) meeting more often – say 2 or 3 days every month instead of 6-12 days every year – would provide more solid direction and awareness of bank business. It is significant during the crisis times or negative sentiments when markets are fast-moving (Choudhry, 2011, pp. 179-211).

8.3. Recommendation 3: Size of Board

According to an observation 15 directions and risk management is likely to stray into higher risk and inconvenient business sectors without effective checks and balances on management. More committed but fewer members would make the bank boards more effective. It is easier to create a sense of personal responsibility with small-size boards; instead of collective position where each broad member takes refuge. In that situation it is more difficult to restrain management and the cult of personality. Considering the size of the bank, the recommendation is to have a board of 6-10 persons instead of the norm of 12-20 would make for more effective supervision and control (Choudhry, 2011, pp. 179-211).

8.4. Recommendation 4: Communication and Engagement

Any material cumulative changes in the share register should be reported to boards immediately. Also boards have to understand the reasons for such changes. The FSA should be urgently informed if material cumulative changes happen over a short period (Walker, 2009, pp. 90-103).

8.5. Recommendation 5: Remuneration Committee

The remuneration committee report should announce for “high end” executives if their total remuneration exceeds the executive board median total remuneration, in bands. Additionally, in each band executives’ numbers’, the main elements of salary, bonus, pension contribution and long-term award should be revealed (Walker, 2009, pp. 90-103). Lastly, remuneration of highly earning people such as traders not necessarily classed as executives should be included (ACCA, 2009).

9. CONCLUSION

After the banking crisis, more effective and stricter corporate governance framework is established by reviewing the Combined Code on corporate governance (UK’s principal regulation on corporate governance) by UK authorities. Financial Reporting Council which is UK’s independent regulator of corporate governance made changes in parallel with the Walker review (Abdumavlonov, 2012, pp. 6-30).

There is an extremely controversial debate about whether failures in the corporate governance of banks were a major cause of the financial crisis. The most of time the truth is in the middle. Actually deficiencies in board practices and profile, compensation practices as well as risk management and internal control failures are inspired by false incentives. Complex and opaque bank structures aggravated this situation. During the time that the contributory role played by these deficiencies, also there were many other and more important causes that led to the financial crisis (Mehran et al, 2011, pp. 1-24).

According to a report by finance leaders, corporate governance of the largest global banks must be improved to ensure stability in the wake of the credit crisis. G-30 report (2012) which also encouraged banks to split the CEO and chairman roles argues that, boards of directors with eight to twelve members and experienced people as chief executive officers or regulators are preferable.

The contribution of poor corporate governance to the crisis is emphasized by Jean-Claude Trichet’s report. In that report firms are advised to build a culture of governance instead of focusing on the processes and rules (Moore, 2012).

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APPENDIX

Bosses' pay at UK banks receiving government support

	Position	Total Pay (Including bonuses) 2007
RSB		
Sir Tom McKillop	Chairman	£750,000
Sir Fred Goodwin	Group Chief Executive	£4,190,000
Jonny Cameron	Chairman, global markets	£3,256,000
HBOS		
Lord Stevenson	Chairman	£821,000
Andy Hornby	Chief Executive	£1,926,000
Peter Cummings	Chief Executive, corporate division	£2,606,000
Lloyds TSB		
Sir Victor Blank	Chairman	£661,000
J Eric Daniels	Group Chief Executive	£2,884,000
Terri Dial	Group Executive Director	£1,995,000
Bradford & Bingley		
Rod Kent	Chairman	£265,000
Steven Crawshaw	Group Chief Executive	£1,112,458
Chris Wilford	Group finance director	£700,572
Northern Rock		
Matt Ridley	Chairman	£223,000
Adam Applegarth	Chief Executive	£785,000
David Baker	Deputy chief executive	£476,000

Source: BBC News, 2009